ANNEXURE B13

HESSEQUA MUNICIPALITY

BORROWING, FUNDS AND RESERVES POLICY

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1. INTRODUCTION

The documented **Borrowing, Funds and Reserves Policy**, sets out the framework for the prudent use of Borrowing, Funds and Reserves available to Hessequa Municipality.

This Policy should be implemented in conjunction with the approved ***Liquidity Policy***. The Liquidity Policy sets out the prudent level of cash to be maintained by the Municipality as one of several factors to ensure long term financial sustainability. It is however of equal importance to protect, maintain and extend the infrastructure of the Municipality to ensure the continued provision of services at an acceptable standard.

This policy is implemented to provide guidance on the appropriation of capital funding resources on a sustainable basis in the longer term.

2. BACKGROUND AND APPROACH

With reference to the applicable legislation as referred to in paragraph 3 below. Legislation exists and prescribes the framework of a Borrowing as well as Funds and Reserves Policy and these factors will all be addressed in this Policy.

Although legislation provides guidance as to the broader framework to ensure financial management of resources to ensure the Council meets all of its obligations timeously, it is not prescriptive with regards to quantifying not only the prudent level of Borrowing, Funds and Reserves but more so the optimal level hereof.

Therefore in this Policy cognisance has been taken of the legislative guidelines whilst more prescriptive guidelines are set for the optimal management and monitoring of resources to the Municipality's avail based on sound financial practices.

3. LEGISLATIVE REQUIREMENTS

The legislative framework governing borrowings, funds and reserves are:

3.1. Local Government Municipal Finance Management Act, Act 56 of 2003 (MFMA) must be complied with; and

3.2. Local Government Municipal Budget and Reporting Regulation, Regulation 393, published under Government Gazette 32141, 17 April 2009.

4. FUNDING POLICY

The Local Government Municipal Budget and Reporting Regulation, Regulation 393, published under Government Gazette 32141, 17 April 2009 stipulates:

8. (1) Each municipality must have a funding and reserves policy which must set out the assumptions and methodology for estimating –

(a) projected billings, collections and all direct revenues;
(b) the provision for revenue that will not be collected;
(c) the funds the municipality can expect to receive from investments;
(d) the dividends the municipality can expect to receive from municipal entities;
(e) the proceeds the municipality can expect to receive from transfer or disposal of assets;
(f) the municipality's borrowing requirements;
(g) the funds to be set aside in reserves.

In terms of Section 18 and 19 of the MFMA an **annual budget** may only be funded from:

Cash backed accumulated funds from previous years' surpluses not committed for other purposes:

Transfers from the accumulated surplus to fund operating expenditure will only be allowed for specific once-off projects with no recurring operating expenditure resulting thereof.

Borrowed funds, but only for capital projects:

Actual capital expenditure may only be incurred on a capital project if the funding for the project has been appropriated in the Capital Budget, but has also been secured from the financial source that is not committed for another purpose.

Realistically anticipated revenues to be collected:

Realistic anticipated revenue projections must take into account projected revenue for the current year based on actual collection levels in previous financial years.

4.1. OPERATING BUDGET

The Operating Budget should be cash funded. The Operating Budget is funded from the following main sources of revenue:

a) Property Rates;
b) Surplus generated from Service Charges;
c) Government Grants and Subsidies;
d) Other revenue, fines, interest received etc.;
e) Cash backed accumulated surpluses from previous years not committed for any other purposes.

The following guiding principles apply when compiling the Operating Budget:

a) The annual budget must be balanced;
b) Growth parameters must be realistic taking into account the current economic conditions;
c) Tariff adjustments must be in line with the following approved policy: ***Principles and Policy on Tariffs and Free Basic Services***;
d) Revenue from Government Grants and Subsidies must be in line with allocations gazette in the Division of Revenue Act and provincial gazettes. Transfers of a conditional nature must be appropriated only as prescribed and should not be used to fund the Operating Budget;
e) Revenue from public contributions, donations or any other grants may only be included in the Budget if there is acceptable documentation that guarantees the funds and if the transfers are unconditional of nature;
f) Provision for revenue that will not be collected is made against the expenditure item bad debt and based on actual collection levels for the previous financial year and the reasonably projected annual non-payment rate;
g) The profits generated from any sale of land or investment property is to be contributed to the Capital Replacement Reserve;
h) A detailed salary budget is compiled on an annual basis. All funded positions are budgeted for in total and new and/or funded vacant positions are budgeted for six (6) months only of the total package considering the recruitment process. As a guiding principle the salary budget should not constitute more than 35% of annual Operating Expenditure;
i) Depreciation charges are fully budgeted for according to the Asset Register.
j) However, the annual cash flow requirement for the repayment of borrowings must fully be taken into consideration with the setting of tariffs;
k) Sufficient provision must be made for the maintenance of existing infrastructure based on affordable levels. The maintenance budgets are normally lower than

the recommended levels. The reduction of maintenance budgets to balance the annual budgets must be carefully considered. As a guiding principle repair and maintenance should constitute between 5% and 8% of total operating expenditure and should annually be increased incrementally until the required targets are achieved;

l) Individual expenditure line items are to be revised each year when compiling the budget to ensure proper control over expenditure.

4.2. CAPITAL BUDGET

The capital budget provides funding for the municipality's capital programme based on the needs and objectives as identified by the community through the Integrated Development Plan and provides for the eradication of infrastructural backlogs, renewal and upgrading of existing infrastructure, new developments and enlargement of bulk infrastructure.

The capital budget is limited by the availability and access to the following main sources of funding:

a) Accumulated cash backed internal reserves such as the Capital Replacement Reserve;
b) External borrowings;
c) Government Grants and Subsidies;
d) Public Donations and Contributions.

The following guiding principles apply when considering sources of funding for the capital budget:

a) Government Grants and Subsidies:

a. Only Government Gazetted allocations or transfers as reflected in the Division of Revenue Act or allocations as per Provincial Gazettes may be used to fund projects;
b. The conditions of the specific grant must be taken into consideration when allocated to a specific project; and
c. Government Grants and Subsidies allocated to specific capital projects are provided for on the relevant department's Operating Budget to the extent the conditions will be met during the financial year.

b) Public Donations and Contributions:

a. In the case of public contributions, donations and/or other grants, such capital projects may only be included in the annual budget if the funding is guaranteed through a legally binding document;
b. Public donations, contributions and other grants are provided for on the relevant department's Operating Budget to the extent the conditions will be met during the financial year.

c) External Borrowing:

a. The borrowing requirements as contained in the **Borrowing Policy** in paragraph 6 are used as a basis to determine the affordability of external loans over the Medium Term Income and Expenditure Framework. The ratios to be considered to take up additional borrowings are as follows, unless in contravention with any loan covenants:
    i. Estimated long-term credit rating of BBB and higher;
    ii. Interest Paid to Total Expenditure not to exceed 5%;
    iii. Total Long-term Debt to Total Operating Revenue (including current grants) not to exceed 35%;
    iv. Operating Cash Surplus generated before loan repayments are made covers the Total Annual Repayment at least 1 time;
    v. Percentages of Total Annual Repayment (Capital and Interest) to Operating Expenditure to be less than 10%.

d) Cash backed Reserves

a. Allocations to capital projects from cash backed internal reserves will be based on the available funding for each ring-fenced reserve according to the conditions of each reserve. With reference to Paragraph 5, **Reserves Policy.**

All capital projects have an effect on future operating budget therefore the following additional cost factors should be considered before approval:

a) Personnel cost to staff new facilities once operational;
b) Contracted services, that is, security, cleaning etc.;
c) General expenditure such as services cost, stationery, telephones, material etc.;
d) Other capital requirements to the operate facility such as vehicles, plant and equipment, furniture and office equipment etc.;
e) Costs to maintain the assets;
f) Interest and redemption in the case of borrowings;

g) Depreciation charges;
h) Revenue generation as the additional expenses incurred may be offset by additional revenue generated to determine the real impact on tariffs.

5. RESERVES POLICY

All reserves are "ring fenced" as internal reserves within the accumulated surplus, except for provisions as allowed by the General Recognized Accounting Practices (GRAP).

As at 30 June 2012 the only reserves held by Hessequa Municipality were with respect to:

a) Housing Reserve with a cash balance of R 53,583;
b) Revaluation Reserve with a zero balance used for accounting purposes.

Hessequa Municipality endeavours to establish a **Capital Replacement Reserve** for the funding of capital replacement and renewal for future financial years. This reserve needs to be cash backed. This will provide Hessequa Municipality with a more balanced capital funding approach in the longer term thereby reducing the risk of reaching its maximum gearing ability or depleting its free cash.

This Reserve can be generated as follows from the Operating Budget:

a) Cash from Depreciation Charges:

a. In the past depreciation charges could be considered insufficiently cash backed based on the cash surplus generated prior to capital spending;
b. The increased asset value as a result of GRAP 17 has resulted in Depreciation charges increasing sharply which was not fully supported by cash;
c. Depreciation is a method to generate future cash. Therefore it is anticipated to annually improve the cash coverage for depreciation charges until it is fully funded from cash through tariff setting;
d. Whereas in the past the cash generated was appropriated to capital infrastructure in the same financial year, cash generated from depreciation charges will be appropriated to the Capital Replacement Reserve and no more than 30% of the balance as at year end should be allocated to the following year's capital budget unless sufficient recommendations are made to Council to substantiate such a decision.

b) Interest received on the investment made for the Capital Replacement Reserve

6. BORROWING POLICY

It is required that the Municipality comply with the guidelines of Chapter 6 of the MFMA with regards to Debt Disclosure as detailed in Sections 46, 47, 48 and 49. This section should be read in conjunction with point c) under paragraph 4.2. on page 6. External borrowings may only be incurred for approved capital programmes and may under no circumstances be allocated to fund the Operating Budget.

Municipal infrastructure has a long-term economic life and it is appropriate to fund assets of this nature with long term external borrowing. The economic life of assets should be equal to or longer than the tenure of the external borrowing.

The following needs to be taken into consideration when accessing external borrowing:

a) Types of loan financing

a. Annuity Loans enable the Municipality to provide for the redemption of loans on an amortising basis which is generally the most cost effective method of financing often referred to as vanilla funding;
b. Bullet Redemption Loans are attractive as interest on the loan is serviced with the capital redemption only taking place at the end of the tenure of the loan. However, this method is more costly as interest is paid on the full debt throughout the term as the Capital does not reduce. This type of loan also requires an annual contribution to a sinking fund, which in essence then mimics the traits of an annuity loan although at a higher cost. The use of such structure warrants a detailed motivation based on the benefits to the implementation of the capital project;
c. Sculpted Repayment Loans offer a combination of the above two types, as loans are sculpted according to the potential cash flows to be generated from the capital project in future. For example the following can be included in a sculpted loan:
    i. A capital grace period in the first years of the development of the capital project;
    ii. An incremental annual increase in the repayment in relation to the projected growth in revenue from the project.

b) Interest Rate Risk Management

a. The impact of interest and capital redemption payments on both the current and forecasted property rates and service charges through tariffs taking into

consideration the current and future capacity of the consumer to pay therefore;

b. Likely movement in interest rates for variable rate borrowings. There are benefits to be yielded from borrowing on a variable rate if rates are projected to decrease in future, however it is prudent for Hessequa Municipality to enter into fixed interest rate loans to accurately budget for expenses incurred.

c) Tenure of Borrowing

a. The tenure of external borrowings should where possible match the economic useful life of the asset.

d) Security

a. Unless sufficient motivation is provided and other than for the provision of a sinking fund for the redemption of a bullet loan, the provision of any security against external borrowings, should be specifically motivated by the CFO for approval.

e) Loan Covenants

a. Hessequa Municipality is to maintain a Loan Covenants Register detailing the covenants entered into with each active loan agreement until date of maturity thereof;
b. Compliance with all loan covenants are to be monitored and reported on semi-annually to ensure Hessequa Municipality does not breach any covenants;
c. Should a default be triggered based on non-compliance with loan covenants, Hessequa Municipality is to alert Council and send the related Financial Institutions a written commitment to address the matter within a reasonable timeframe.

f) Level of gearing

a. As stipulated in point c) under paragraph 4.2. on page 6, gearing is not only limited by the level of debt against the Total Operating Income (excluding conditional grants) but also limited by other operational factors including compliance with the stipulations of the approved ***Liquidity Policy***.
b. Should Hessequa Municipality not be in contravention with any stipulations in this policy or any other approved financial policy, then it is recommended

that Hessequa Municipality maintain external gearing at levels not lower than 25% but not higher than 40%.

7. CORPORATE GOVERNANCE (OVERSIGHT)

Compliance with the various stipulations as documented in this Borrowing, Funds and Reserves Policy need to be monitored by the Chief Financial Officer and reported on to the Municipal Manager on an annual basis at the current financial year end. Furthermore the impact of implementing the Medium Term Revenue and Expenditure Framework is to be reported to the Municipal Manager and to the Council before approval thereof annually.

Where compliance has been breached the Chief Financial Officer must present an action plan to correct the non-compliance. The Finance Committee must monitor the successful implementation of the corrective action plans and report progress to Council.

8. TRANSITIONAL ARRANGEMENT

Upon adoption of this policy by the Council, the Municipal Manager in conjunction with the Chief Financial Officer must determine the current performance levels of Hessequa Municipality against this Policy and present a plan of action towards achieving the stipulation as set out in this policy.

The Council must approve an appropriate timeframe within which Hessequa Municipality must achieve the approved stipulations as set out in this Policy. The period between the date of the policy adoption by Council and the target date for compliance shall be known as the Transitional Period.

The Finance Committee must report progress during the approved Transitional Period to the Council.

9. POLICY MANAGEMENT

The Borrowing, Funds and Reserves Policy forms part of Hessequa Municipality overall financial objectives and therefore forms part of approved Budget Policies. The policy must be reviewed at least annually during the budget revision and presented to Council for approval.

The Policy is effective from the date it is approved by Council.